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TAX REFORM IMPACT ON NONPROFITS

The Tax Cuts and Job Act was passed in December 2017, but the total impact to nonprofits will not really be known until we get through 2018. The reason, not only are there direct impact items in the Act, but there are also indirect impact items. It is very likely that the indirect impact items will have a greater effect on nonprofits.

For direct impact there are six primary items affecting nonprofits, and it is quite possible that none of these items will affect your organization.

- The calculation for unrelated business income (UBI). Not all nonprofits have UBI, and there has been no change in the definition of UBI. So, if you have not previously filed a Form 990T, Exempt Organization Business Income Tax Return, you are most likely not affected. For those that do report UBI, the income should now be calculated separately for each unrelated trade or business activity – therefore UBI from one activity can no longer be used to offset the income of another unrelated activity. Also, net operating losses can no longer be carried back. Carryforwards will not expire, but are limited to 90 percent of taxable income. And finally, the UBI tax rate will now be a flat 21 percent.
- Excise tax on executive compensation. Executive compensation in excess of $1 million will now be subject to 21 percent excise tax. In addition, there will be an excise tax on excessive parachute compensation paid to any covered employee making over $120,000. Some quick definitions: *Covered employees* are any current or former employees that are reported as one of the five highest compensated employees on the Form 990, Return of Organization Exempt Form Income Tax. *Parachute payments* are generally any payments that exceed three times an employee's base compensation. This excise tax assessment considers eligible executives as anyone who has ever been reported as a covered employee on a Form 990 for tax years beginning in 2017 and thereafter. Also, expect some additional scrutiny of employees being classified as contractors or employees compensated through pass-through entities, the IRS may be looking for individuals paid as contractors as a means to avoid the excise tax.

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THE INDIRECT IMPACT OF THE TAX REFORM ACT SEEMS TO BE GENERATING MORE CONCERN.

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- Excise tax on certain private colleges and universities endowments. For institutions that have at least 500 tuition paying students for which more than 50 percent of these students are located in US, that are not defined as a state college or university and have an aggregate fair market value of assets of at least $500k per student at the end of the preceding tax year, the investment income will now be subject to a 1.4 percent excise tax.
- Funds used to pay for employee transportation fringe benefits and on-premises athletic facilities will now be treated as unrelated business income.
- Interest income received by investors on advance refunding bonds will no longer receive a tax break. Quick definition: *Advance refunding bonds* are used to refinance debt at lower rates and to pay principal, interest, or the redemption price on a prior bond issue. These bonds would be issued more than 90 days before the redemption of the prior issue.
- Charitable deductions for athletic seating rights will no longer be allowed.

The indirect impact of the tax reform act seems to be generating more concern. Will donors continue to donate at the same level if they are not receiving a tax deduction? There is no way to gauge this. While many donors give to support the public good, there are those for which a reduction in taxable income is an incentive to donate. To better understand the indirect impact of the tax reform act, we have summarized some of the pertinent provisions related to charitable giving.

- The standard deduction has increased. For single tax payers it is now $12,000 as opposed to $6,350 and for married taxpayers $24,000 as opposed to $12,700. Also, individuals will only be able to deduct up to $10,000 of state and local taxes when itemizing. Bottom line, less people will be itemizing their deductions and therefore not using charitable giving as a vehicle for tax savings.
- For individuals that do itemize, they will now be able to donate up to 60 percent of their adjusted gross income (AGI) to charity as opposed to the previous 50 percent. The five year carryover for donations in excess of the limit has not changed.
- Estate and gift tax unified credit exclusion has increased to $11.2 million (adjusted for inflation), from $5.6 million. Bequests to charitable organizations are allowed to reduce the amount of an individual's estate that is subject to tax.

So while there is a chance that there may be a reduction in giving for those no longer itemizing, there is also opportunity for increased giving from high net worth donors. In addition, there are still some charitable giving tools that continue to receive beneficial treatment.

- Donating appreciated stock avoids capital gains taxes. The donor records a tax deduction for the fair market value when donating qualified appreciated stock; the nonprofit organization recognizes revenue for the fair market value of the stock at the date of transfer.
- Donors aged 70 ½ or older can still donate their required minimum distribution from their IRA for beneficial tax treatment. The donation alleviates reporting the distribution as taxable income.
- Planned giving. Naming a nonprofit the beneficiary of retirement plan assets can avoid tax burdens on the donor's heirs.

Overall, the industry feels that donors will continue to support causes and organizations that they care about, so good stewardship continues to play a prominent role in charitable giving. Consider reaching out to your donors to acknowledge the change in tax incentives and to keep them up to speed on those giving methods that still receive favorable tax treatment.

As always, UHY, LLP is here to help. We invest significant time in understanding tax reform and other developments in the nonprofit sector in order to ensure the success of our clients. Please do not hesitate to contact your UHY LLP team member if you are in need of assistance.

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NEW REVENUE RECOGNITION STANDARDS FOR NONPROFITS

After several years of stability in the accounting standards for nonprofit organizations, the new FASB standards need to be addressed soon on several different issues. Most of the preparation has focused on ASU 2016-14 *Presentation of Financial Statements*, which is effective for years beginning after Dec.15, 2017. Some organizations have not yet begun to consider the standards of ASU 2014-09, *Revenue from Contracts with Customers*, which will be effective for most nonprofit entities for periods beginning after December 15, 2018, except for certain entities who have conduit debt which is not a private placement that have earlier adoption requirements.

While contributions are not covered under the new standard, current standards for contribution recognition, including recognition and valuation of pledges and restriction of use for gifts still need to be carefully implemented and documented. Investment income, a significant source of revenue for some nonprofits, is also not covered by the new standard.

In June 2018 FASB issued ASU 2018-08 *Clarifying the Scope and the Accounting Guidance for Contributions Received and Contributions Made*, which provides additional guidance on determining whether a transaction is a contribution or exchange transaction as well as distinguishing between an unconditional or conditional contribution. It will be effective for most entities beginning after December 15, 2019 with early adoption permitted.

Most organizations will be affected by the new revenue recognition requirements of ASU2014-09 even though nonprofits have not traditionally thought of their constituents as "customers". Depending upon the nature of the entity and the variety of income sources, your organization should be taking steps now to be sure you are ready to implement the standard as smoothly as possible.

The first step would be to identify revenues that meet the definition "…inflows…from delivering or producing goods, rendering services, or other activities that constitute the entity's ongoing and major activities". These are exchange transactions with a contract, implicit or implied to provide something with value for goods or services. Some such transactions may be clearly identifiable as meeting the revenue definition, such as tuition payments at a college, or not meeting the definition, such as a contribution to mental health organization that does not provide any potential benefit to the donor.

Many revenue sources, though, may have elements of both a contribution and an exchange transaction. Some organizations, for example, may include such things as a subscription to a professional publication, passes to a museum, use of athletic facilities, or discounts on purchases from a gift shop for those who contribute or as part of membership fees. The components of these transactions need to be identified and separated in order to determine the appropriate timing of recognition of each element.

Grants from government or private sources also need to be carefully understood to determine if they have one or more performance obligations which must be met or if they are a voluntary non-reciprocal transaction. Generally, cost-reimbursable grants will continue to be accounted for as they have traditionally been under existing guidance, revenue is recognized as allowable expenses are incurred.

If your organization has not already begun to prepare for implementation of the standard, you should begin considering it as soon as possible. It takes time and effort to gather the information needed to be ready to implement the standard. Nonprofits, like those in the commercial sector, may find they have to make sensitive judgments about classification and estimates of value of various components of revenue.

Organizations need to first identify whether the revenue is a contribution or an exchange transaction. If it does not qualify as a contribution, there are five steps that FASB has identified that must be performed before determining when revenue is recorded. The core principle is that revenue is only recorded when goods (or services) are transferred for an agreed-upon price.

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Each organization must:

- Identify the contract.
- Identify the performance obligation under the contract.
- Determine the price.
- Allocate the transaction price to the various performance obligations.
- Recognize revenue as the entity satisfies the performance obligation(s).

ASU2018-08 provides two elements to consider in making the distinction between a contribution and an exchange transaction:

- Indirect benefit received by the public is not equivalent to commensurate value received by the resource provider.
- Continuing the nonprofit's mission or positive sentiment from being a donor does not constitute commensurate value.

A research grant, for example, could be a contribution or an exchange transaction, depending upon its terms and each grant will need to be analyzed individually.

The nonprofit community encompasses such a wide variety of size, focus and mission, that general guidance is very difficult to provide. Every entity is unique. Some organizations will have very few changes in how revenue is recognized and others may require substantial changes in timing or revenue recognition, requiring system changes and additional data collection and analysis. Organizations such as NACUBO and other national industry membership groups can be helpful in exchanging information on implementation strategies and identifying potential areas of concern.

A contract is defined as "an agreement between two or more parties that creates enforceable rights and obligations". The standard contains additional guidance regarding multiple contracts and contract modifications.

If the transaction meets the contract definition, the performance obligation(s) need to be identified. Where there are promises in a contract to deliver more than one good or service, they must be accounted for separately if they are distinct within the context of the contract and if the customer can benefit either on its own or together with our resources.

Once these obligations have been identified, if the consideration is variable, the transaction price may be required by estimating either the expected value or the most-likely amount to be realized. If there are separate performance obligations, the transaction price would be allocated to each.

Only after this analysis has been completed are you ready to determine when the performance obligation(s) are satisfied, and accordingly, when revenue is recognized under the standard.

Transactions that might seem similar at first, could result in markedly different recognition treatment once they are individually analyzed. For example, let's take two nonprofit organizations, one an animal shelter and the other a professional membership organization. Both provide a monthly newsletter to their "members". In the case of the animal shelter, the "membership" does not provide any reciprocal benefit, it is really a contribution and the newsletter is provided free to anyone who asked for it (and many others on a mailing list). Absent any other factors, the transaction would be recorded as a contribution.

The professional membership organization however has a contract to provide various services to their members over the period, one of which is the monthly publication which is also sold to non-members for an annual subscription price of $100. If the dues are $350 annually, the performance obligations would be distinct and $100 would be allocated to subscription revenue and $250 to membership services.

Timing of the distinct revenue recognition might in this instance be the same, on each month over a 12 month period.

The standards will also require additional disclosures about the accounting policies, and in certain cases, specifics about the elements and basis for estimation of allocations, including both qualitative and quantitative information "to enable users of financial statements to understand the nature, amount, timing and uncertainty of revenue and cash flows arising from contracts".

For transactions which have been determined to be contributions through the previous analysis, there is new guidance as to whether a contribution is considered conditional or unconditional. Conditional contributions must have:

- Either a right of return of assets transferred or a right of release of a promisor's obligation to transfer assets; AND
- A barrier that must be overcome before the recipient is entitled to the assets transferred or promised.

Again, each grant or contribution will need to be individually analyzed in order to determine the appropriate revenue recognition to apply.

The objective of the new FASB standards is to enhance the usefulness of financial statements through greater comparability and meaningful disclosures. Transition to the new standards will be complicated and implementation will require significant time and effort. UHY LLP can work with your management team to provide assistance in contract analysis and information gathering to help with of the standard.

Marilyn Pendergast,
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NOT-FOR-PROFIT INDUSTRY INSIGHT

With the increasing complexity of laws and regulations, it's important for associations, foundations, charities, hospitals, schools and other tax-exempt entities to seek out professionals with extensive experience in nonprofit compliance issues. We understand there are many challenges affecting the industry and provide the attention needed to help clients stay focused on their job at hand.

UHY LLP's National Not-For-Profit Practice offers comprehensive audit and assurance, tax planning and compliance and business advisory services to meet the unique, complex needs of nonprofit organizations.

These types of specialized services, which cut across the traditional service lines, demonstrate our philosophy of skilled professionals integrating industry expertise with technical services.

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